

CAPITAL SOLUTIONS NEWSLETTER...

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A pair of blog posts detail the inherent problem with Venture Capital math, while Q1 exits raise hopes for an industry rebound. For entrepreneurs, social media's value as a sales channel is still questionable, while at least one VC gazes down Madison Avenue and sees a looming cliff. Finally, when investing in a downturn, it really hurts to be a man.

The Problem with Venture Math

[Last month](#) we looked at the external factors partly responsible for the consolidation of the venture industry. What also bears consideration is the internal economics of the industry itself. As the industry grew and both the number of funds and fund sizes increased, the returns that venture funds promised their limited partners extended into the stratosphere. The simple math behind most venture funds ended up encouraging investments with enormous risk profiles, while companies with a lower risk/reward profile had a harder time attracting capital.

You can either look at this problem from an [industry perspective](#) (via Fred Wilson), or from the view of a [single fund](#) (via Josh Kopelman). To quote from the latter:

Take a \$400M venture fund. In order to get a 20% return in 6 years, they need to triple the fund -- or return \$1.2B. Add in fees/carry and you now have to return \$1.5B. Assuming that the fund owns 20% of their portfolio companies on exit, they need to create \$7.5B of market value. So assume that one VC invested in Skype, MySpace and Youtube in the same fund - they would be just halfway to their goal.

Both posts are good reading, and they underscore a fundamental mismatch: with new technologies and processes, many entrepreneurial companies are increasingly capital efficient -- requiring less investment, but particularly with the limited IPO market, also with lower exit value. At the exact same time, the appetite for longshots increased at most VC firms, with an emphasis on the exit and placing more capital; thus spurning a basic imbalance between supply and demand.

For most executives, Josh drives home a critical point: "A company's outcome should drive VC returns. When VC's required returns drive company's outcomes, it's a recipe for trouble." As you consider capital sources, make sure the their return expectations are aligned with your reality.

Return of the Happy Ending?

The first quarter exit numbers were overwhelmingly positive, as the [NVCA](#) reported the highest quarterly transaction total for VC-backed acquisitions ever, with 111 deals representing almost \$6 billion in value. Likewise, the public markets began to open again, as there were nine VC-backed IPOs raising over \$930 million in Q1, compared to just [8 total VC-backed IPOs](#) in all of 2009 (full data is [HERE](#) in PDF). Moreover, it appears that [venture fundraising grew](#) over an anemic 2008, with multi-stage funds garnering the lion's share.

NVCA's analysis of the M&A deals compared the transaction value to the amount of venture money invested. For disclosed deals, fully 31% had a transaction value less than the total venture money invested, and 24% returned 1-4X. Another 31% had a transaction value of 4-10X venture investment, while 14% had transaction value of 10X or greater. Now this comparison is somewhat askew, as VC firms will not own 100% (or usually even a supermajority), so a 4X return implies that a venture investor probably received considerably less than 4X.

Now, back to VC math: my unsupported belief is that the deals that fail to return venture investments are much more likely to be undisclosed, while acquisitions by public companies are far more likely to be both larger and disclosed, so I expect the data skews positive. However, even if it did not, at least 55% of the exits returned less -- most of them much less -- than 4X, which would not meet the return threshold of most firms. The venture industry's ability to predict the future is [deeply flawed](#), and optimist here should be tempered. With the golden era of venture investing [now off the books](#), the ability to sustain returns will largely determine the future health of the venture industry, and access to capital for many entrepreneurial companies.

To Tweet or Not To Tweet?

Valuations of Facebook, Twitter, and other social media companies have been constructed, in part, around the idea that their platforms will serve as facilitators for commerce - particularly for small businesses that lack large advertising budgets. Some [initial evidence](#) now seems to say that expectations may overwhelm reality.

With a survey showing that only a tiny percentage of small companies see a profit rather than a loss, and most see no financial benefit at all (and self-reporting surveys tend to understate bad news). But the digital revolution shows no sign of complacency, so if you must tweet till your facebook is blue, here are [five things to avoid](#), plus another [five to consider](#).

The Madness of Ad Men?

Venture professionals have no life? Well, witness the always engaging Jeff Busgang admit that he is just now starting to watch the television drama [Mad Men](#), which is entering its fourth season. However, Jeff uses the occasion to reflect on his recent dinner with Madison Avenue advertising CEOs, and finds [four reasons why their companies are doomed](#): earning pressure on public firms; diminishing senior relationships; a trend towards pay for performance, and a lack of new talent.

Certainly there has been [considerable activity](#) in the digital advertising sector -- particularly in [mobile](#). Like the martini-drenched breaks in Mad Men, many of these seem a distraction from the core business -- but all too soon these distractions become the focus. The digital advertising space is highly dynamic, and the continued reaction of Madison Avenue to the rapid waves of entrepreneurial activity bears watching. The next CEO advertising dinner could be brown bag.

When Being a Man Hurts...

One of the keen observations of Mad Men is that the show's women - even constrained as they are by 1960's social roles and the lack of professional opportunities - are generally more capable than then men. A [recent study](#) by the mutual fund company Vanguard suggests that investing in an economic slump may be another area where the male [Y chromosome](#) is a liability.

Rather than being due to any particular strategy, it turns out that overconfidence in their own abilities meant that during the financial crises, men suffered disproportionate market losses than women. As the [New York Times](#) summarized:

"There's been a lot of academic research suggesting that men think they know what they're doing, even when they really don't know what they're doing," [the study's author] said. Women, on the other hand, appear more likely to acknowledge when they don't know something - like the direction of the stock market or of the price of a stock or a bond.

Well guys, take a break from asking directions and acknowledge -- particularly for those of you who opened your portfolio statements in late 2009 -- that it's okay to cry.

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